



**WILLS AND
INHERITANCE TAX AVOIDANCE
- A Brief Guide -**

Child & Child have been making Wills, dealing with inheritance tax/estate planning and administering clients' estates for over 150 years. This booklet has been written to highlight some points based on this experience.

1. WHY MAKE A WILL?

If a person dies without leaving a Will:

- His assets will be divided according to strict rules, among close relatives by blood and marriage, who in some cases will be difficult to trace. Those whom he might have wished to benefit (for example, an unmarried partner) may be given nothing. Others, whose needs are less or whom he might not have wished to benefit, may receive everything. If the individual has no close relatives, all his assets may go to H.M. Treasury.
- The deceased's home may have to be sold, against the wishes of the surviving spouse (* **see below**) so that other beneficiaries are able to receive their entitlement.
- An unsuitable trust may be imposed, with restrictions on the trustees' powers of investment and restrictions on how much of the estate can be used for children's maintenance and education.
- Inheritance tax may apply, when it could sometimes be avoided.

A Will allows the individual to choose what happens to his assets when he dies. It is likely to save time and expense. It makes life easier and more certain for those whom he leaves behind, in what will be a difficult and stressful period for them. He

is able to choose and appoint executors, whom he trusts, to look after his affairs, and guardians to look after his young children.

** Note: In this guide, the term “spouse” means a wife, husband or registered civil partner.*

Individuals fail to make Wills for various reasons. Examples are:

- Some think that they have nothing to leave – it is surprising how much one’s home, its contents, life assurance policies and other items are worth when added together.
- Some are not sure how to deal with their assets – but the Will does not have to list the assets and can be worded flexibly.
- Some think that a Will is irrevocable - in fact it can be revoked by destruction or by a subsequent Will and is normally revoked by a subsequent marriage. If minor amendments are needed, the Will can be altered by a codicil.
- Some think that a Will involves too much expense - a well thought out Will with associated inheritance tax and estate planning is a good investment, often avoiding trouble and much greater expense later..

A Will is often an essential tool in the **avoidance** of inheritance tax - this is the open arrangement of one's assets and affairs in a legal manner so as to minimise inheritance tax. It must be distinguished from tax **evasion**, which is a criminal offence and which usually involves concealing assets or transactions from the Inland Revenue.

“No man in this country is under any moral obligation to allow the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow to use every taxing statute to deplete the taxpayer’s pocket. Correspondingly the taxpayer may use every honest and reasonable means to prevent the Revenue from doing so”

Statement to Parliament by Sir John Anderson, Chancellor of the Exchequer, 1924

2. INHERITANCE TAX ON DEATH

Assuming that there have been no major lifetime gifts by the deceased affecting the position, the basic rule is that the deceased's estate is taxed at nil rate on the first slice of the estate and at a flat rate of 40% on the balance above that threshold. The nil rate sum for the year ending 5th April 2008 is £300,000. It has been announced that the nil rate sums for the following years are to be as follows:-

Year ending 5 th April 2009	£312,000
“ “ “ “ 2010	£325,000
“ “ “ “ 2011	£350,000

Domicile and Deemed Domicile

The territorial limits for inheritance tax (“IHT”) are decided by the deceased's **domicile** rather than by his **residence**, (which is used more for income tax and capital gains tax purposes). Everyone has a single domicile - there is no concept of dual domicile. The law imposes a "domicile of origin" on every individual when born, which is normally the domicile of the individual's father. In later life it is possible for the domicile of origin to be replaced by a "domicile of choice," by showing that the individual has moved to another country with the intention of making it his permanent home, but it is usually difficult to establish this in practice.

The basic rule is that

- (i) if the deceased is domiciled in the UK, inheritance tax extends to his worldwide assets and
- (ii) if the deceased is domiciled outside the UK, IHT is charged only on his assets in the UK.

However, under UK law, there is a special "deemed domicile" rule. An individual is deemed to be domiciled in the UK for IHT purposes (so that his worldwide assets

will be subject to IHT) if

- (i) he has been **resident** in the UK for 17 out of the last 20 tax years or
- (ii) he has been **domiciled** in the UK at any time in the previous 3 years.

In the case of individuals who are not domiciled or deemed domiciled in the UK, it is usually advisable to ensure that any substantial assets are situated outside the UK, for example in the Channel Islands or the Isle of Man. There are a variety of ways in which this can be achieved. For example, an individual buying a house or flat in the UK for letting purposes will often purchase through an offshore company and, if there is a danger of him becoming domiciled or deemed domiciled in the UK in the near future, the shares in such a company will usually be placed in an offshore discretionary trust. Under such a trust, the individual will be among the possible beneficiaries, but he will have no legal entitlement in relation to the trust assets, which will therefore be exempt from IHT on his death. However, if the property is to be occupied by the individual at times, then its purchase in the name of an offshore company may incur an income tax charge on the individual.

3. **IHT EXEMPTIONS**

There is a wide range of exemptions. Some of the main exemptions are as follows:-

The Spouse Exemption

Gifts to spouses are normally exempt from IHT without limit. This includes assets which are the subject of a life interest in the donor's Will in favour of the spouse - this is where the spouse has the right to income, but no right to any capital.

However there are two traps:

- (i) this exemption does not apply to couples who have not married or registered a civil partnership, no matter how permanent the relationship, and
- (ii) if the donor spouse is domiciled (or deemed domiciled) in the UK and the recipient spouse is not, the gift is exempt up to a maximum of £55,000 only. In the case of couples married before 1st January 1974, the wife

automatically acquired on marriage the same domicile as her husband. This rule does not apply to marriages on or after that date - in this case her domicile is not necessarily the same as her husband's.

The Charity Exemption

Gifts to registered charities are exempt from IHT, without limit.

Business Property Relief

This relief covers

- (i) an interest in an unincorporated business (i.e. sole trader or partnership) - here the relief is 100%
- (ii) shares in an unquoted company - here the relief is also 100% and
- (iii) shares in a quoted company which carry control of the company - here the relief is 50%

The relief is subject to various conditions. The main ones are:

- the business must be carried on for gain
- relief is not available for investment companies or companies dealing in land or shares
- the business property must have been owned for at least two years
- the business property must not be subject to a binding contract for sale

Lifetime Gifts

Most lifetime gifts are exempt from IHT without limit, provided that

- (i) the donor lives for at least seven years thereafter and
- (ii) the donor does not reserve or receive any benefit in a gifted asset

However, a gift is a “disposal” for capital gains tax purposes, so the donor needs to beware of this tax if an asset other than cash is given.

Such gifts operate to reduce the usual nil rate sum (referred to in Section 2) in the event of the donor’s death during the seven year period after the gift.

The annual IHT exemption:

Transfers of up to £3,000 in each tax year are exempt. Any exemption not used in

one tax year can be carried forward to the next, but no further.

Marriage gifts:

Gifts in consideration of marriage are exempt, as follows:-

- | | | |
|--|---|--------|
| - by a parent of the bride or groom | - | £5,000 |
| - by a grandparent of the bride or groom | - | £2,500 |
| - by any other donor | - | £1,000 |

Small gifts:

Small gifts of up to £250 to any number of people are exempt, provided that the total of gifts per donor to each individual does not exceed £250 in the tax year.

Normal gifts from income:

Lifetime gifts made regularly out of income are exempt, provided they do not affect the donor's usual standard of living. There is no upper limit on the amount which can qualify for this important exemption, which is often overlooked.

4. AVOIDING IHT BY WILL

Married couples:

In the common situation of a married couple with children, it is sensible if there are sufficient assets

- (i) to ensure that each spouse has assets equal to at least the value of the nil rate sum (now £300,000 – see section 2 for the nil rate sum after April 2008)
- (ii) for the Will of each spouse to provide that on the first death assets equal to the value of the nil rate sum are passed under the Will to the children. As an alternative, in the usual case where the surviving spouse might require access to the funds, it is increasingly common in solicitor drafted Wills to provide for assets equal to the nil rate sum to pass into a discretionary trust contained in the Will, which

can then be used to benefit the survivor, without giving rise to IHT on such assets on the survivor's later death. If the correct procedure is followed, £120,000 plus (£300,000 plus X 40%) in IHT should be avoided on the second death.

The traditional problem is finding assets to put into the nil rate sum discretionary trust. Often the main asset is the home – one does not wish to use a share in the home, because part of the capital gains tax exemption relating to it is then likely to be lost on its sale. The solution which can now be adopted usually in such cases is to insert a special clause in the Will, in which the trustees are given power to take an equitable mortgage over the home. This secured debt is then the only asset of the trust. The surviving spouse becomes the sole owner of the home and receives all their deceased partners' other assets. The usual capital gains tax exemption on the sale of the home is then retained in full. The mortgage normally contains a provision that the debt is to be uplifted each year in line with a property prices index, published by one of the large building societies. This should ensure that on the death of the second spouse, when the debt is a deduction from his/her estate for inheritance tax purposes and it is reclaimed from this estate, the debt corresponds to the nil rate sum at that time. In effect, the nil rate exemption on the second death should be doubled.

Joint Tenancies & Tenancies in Common:

In Will-making it is very important to ascertain which assets are owned on a joint tenancy. Such assets will pass automatically on death to the surviving co-owner(s), irrespective of the terms of the Will.

For the purposes of inheritance tax planning, as a general rule any substantial assets held in joint names of husband and wife, such as their home, should be owned by them as tenants in common. The aim is to ensure that if husband and wife die within a few weeks of each other the beneficiaries should receive the benefit of two nil rate

inheritance tax sums (i.e. £600,000 plus at nil %). A joint tenancy, where the asset passes on death automatically and immediately to the surviving co-owner, irrespective of the terms of the Will, is usually to be avoided. Large sums of cash (i.e. more than £10,000 or so) should also be deposited in separate accounts rather than in the joint names of husband and wife. Stocks and shares should generally be owned separately.

Life Interest Trusts:

The nil rate sum gift to children or into a discretionary trust is sometimes accompanied by a life interest trust in favour of the surviving spouse. This enjoys the benefit of the IHT spouse exemption, so avoiding IHT on the first death, while protecting the capital for the benefit of the children. This will often be advisable in the case of second marriage, where there are children from the first marriage and it is desired to strike a balance between them and the new spouse.

The life interest would involve the right for the surviving spouse to live in the home, which the deceased owned or had a share in, and the right to receive investment income.

It would of course be open to the surviving spouse (if they wished) to release their life interest wholly or partly, for the benefit of the children, after the death. This would rank as a gift by the surviving spouse and the capital so released would be ignored for IHT purposes after seven years, provided that the surviving spouse does not reserve or receive any benefit after such release.

Joint Fatal Accidents:

To cover the (fortunately rare) situation where husband and wife die in circumstances where there is no evidence that one has survived the other, for example if they die at the same moment in an aircraft crash, it is possible to word the Will of the eldest spouse so that his or her assets pass to the children or other beneficiaries completely free from IHT. This exploits a loophole in the Inheritance

Tax Act 1984, which the Revenue accept.

5. REWRITING THE WILL AFTER DEATH

It frequently happens that the beneficiaries wish to vary the Will. For example, it may leave all the assets to the surviving spouse, who would prefer for various reasons (including IHT avoidance) to see some of the assets passing to the children or into a nil rate band discretionary trust (see Section 4). If all the beneficiaries whose benefit is to be reduced are of full age and agree, it is possible to rewrite the Will by deed of variation within 2 years after the death and to have the revised dispositions treated as if effected by the deceased, for IHT purposes. This device works even if the surviving spouse dies within 7 years of the deed, because the gift is deemed to have been made by the first spouse to die, not by the surviving spouse.

An example shows how the deed of variation works in practice:-

- Lucy, who is a spinster aged 60 years, is left a large sum by her friend Peter on his death. After inheritance tax of £290,000 and various expenses, she receives £680,000 net. She already has total assets worth £500,000, including her house. If she receives Peter's money, it will bear £272,000 ($£680,000 \times 40\%$) in IHT on her later death - in effect the Revenue will have "another bite of the cherry." This worries her, so she seeks professional advice from a solicitor.
- Lucy diverts Peter's money by deed of variation into a discretionary trust. She and the beneficiaries named in her Will are the discretionary beneficiaries, although in practice she will be treated as the primary beneficiary. Lucy and her trusted investment broker are the trustees. However soon Lucy dies, this exercise avoids £272,000 in IHT on Lucy's death.
- If the trustees lend money to Lucy and she spends it, even more IHT is avoided - the debt to the trustees reduces Lucy's estate on her death for the purpose of calculating IHT.

6. INHERITANCE TAX PLANNING IN GENERAL

In practice, there can be no rigid rules for IHT planning. Each case is different and must be examined individually. There are a variety of different ways in which potential IHT liability can be reduced, by the Will and otherwise.

One of the simplest and best methods of IHT avoidance is of course the lifetime gift, for example a cash gift to a child to help them purchase their first home, but for many people substantial lifetime gifts are not an option, financial security in old age being the most important factor.

For married couples, the nil rate sum discretionary trust will described in Section 4 has become popular, because the financial security of the surviving spouse is unaffected.

Single people without children or close relatives might wish to give the nil rate sum at the date of their death to individual beneficiaries and the residue to a charity or charities – such a Will would completely avoid inheritance tax.

There are also some sophisticated insurance-related IHT avoidance schemes, usually involving trusts, promoted by certain insurance companies specialising in this field. Life assurance can also be used in order to fund IHT.

Under pension schemes, there is often substantial death in service cover where payment is discretionary, so that no IHT liability arises on death in relation to this benefit. It is important to deposit a letter of wishes with the pension scheme trustees, stating to whom they should pay the benefit. In some cases, it may be advisable to set up a life-time discretionary trust, with the surviving spouse and descendants as the beneficiaries, to receive this money and so avoid IHT on the money on the later death of the surviving spouse.

7. SUMMARY

There are many considerations to be borne in mind in Will-making and allied planning. Avoidance of IHT and other taxes is of course only one factor and may not be the most important. One must always look at “the big picture” and each case must be looked at individually.

An experienced and objective specialist solicitor, with practical probate knowledge, is a useful ally in identifying the priorities, making an appropriate plan and putting this into effect.

CHILD & CHILD

The information in this booklet is based on the UK law and UK Government budget proposals as at April 2007. It is for basic guidance only. The reader is recommended to seek independent professional advice in every case, before making a Will or implementing any steps aimed at inheritance tax and estate planning, which must also take into account other taxes such as income tax and capital gains tax. Child & Child can advise on UK taxes and law only.

Child & Child are usually happy to act as executors, either alone or jointly with relatives or friends of clients, and to keep original Wills in their Wills store.

Special legal considerations apply to same sex couples, whom Child & Child are pleased to advise, in the light of the Civil Partnership Act 2004, in particular.

Child & Child also deal with Enduring and Lasting Powers of Attorney.

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